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A new world order

Initial propositions on the medium-term implications of the war in Ukraine for the economy and the capital markets

- **Great-power competition is the basis of the new world order**
- **Key driver for radical transformation of the global economy, alongside climate change**
- **Implications for the capital markets are mixed and fraught with uncertainty**

April 2022

Introduction

"Germany had outsourced its security to the United States, its energy needs to Russia and its export-led growth to China." These words from German political commentator and foreign affairs expert Constanze Stelzenmüller, quoted in the Economist[1], explain in a nutshell why Russia's attack on Ukraine marks a fundamental turning point for Germany – probably more so than for virtually any other country. The quote encompasses most of the medium to long-term strategic issues that have been at the top of the priority list since 24 February 2022, if not before: security policy, energy supply, how to deal with countries like Russia and China – and the future of globalisation.

From a capital markets perspective, however, the specific challenges facing Germany are not the main focus. The war in eastern Europe has far-reaching global implications. Unlike the coronavirus pandemic, when everything suddenly changed overnight, Russia's recent aggression did not come out of the blue. To use a musical analogy, there has been a geopolitical crescendo building for years and the Russian invasion is the final cymbal clash. And now a different tune is going to be played.

A new world order is forming

There is already much talk of a new world order. In terms of geopolitical impetus for a new bloc formation, it is already here. But it is likely to be some time before order is restored. At the moment, there is still a great deal of disorder and the situation is extremely unstable. The risks are immense – and for the capital markets this of course means a high level of macrovolatility.

However, our analysis does not explore the short to medium-term aspects of the Ukraine war, such as the consequences for growth and inflation or for monetary and fiscal policy. Instead, this paper focuses on the anticipated medium to long-term structural effects. Although these are merely initial hypotheses, the overall picture that emerges points towards fundamental changes, including in the capital markets. Although primarily regional in scope, they also relate to sectoral and structural features such as payment systems and reserve currencies.

Proposition 1: Return to an old world order: competing great powers instead of globalisation

Flashback to 1990/1991: German reunification was complete and the Soviet Union had collapsed. The Cold War was over. What happened next was a drastic acceleration of (economic) globalisation, closely linked to the economic rise of China. Global trade and foreign direct investment grew sharply and supply chains spanning multiple countries were created. It is only a slight exaggeration to say that everyone traded as much as possible with (almost) everyone else – regardless of political system. Nowhere was this more apparent than in Germany, long-standing world export champion that counted China as one of its most important trading partners for years, even as the country became ever more authoritarian under President Xi. But for a long

[1] The Economist, 5 March 2022 (paywall).

time the primacy of economic interests prevailed, including in Germany's dealings with resource-rich Russia.

Globalisation is being rolled back

Those days are gone. The changes began quietly and almost unnoticed with the financial crisis of 2008/2009. A process that had been clearly signalled from 2017, with the trade dispute between the US and China and subsequent technology sanctions, is now culminating in the response of the West to Russia's invasion of Ukraine and the further developments that are expected here. The basis for the world order is no longer globalisation but (a return to) great-power competition, with economic interests taking a back seat to national or regional security interests.[2] Where strategic dependencies are affected, states are once again intervening more forcefully in national and international economic affairs. Policymakers are aware of and prepared to accept economic inefficiencies. In some sectors, globalisation is being pushed into retreat and is fragmenting.

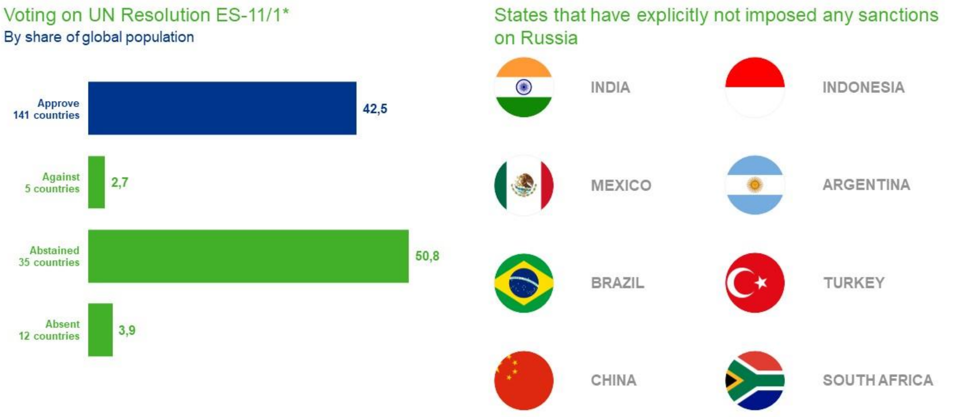
Bloc alignment finally settled

Viewed in this light, the Ukraine war is making clear where the front lines in this competition between great powers lie – perhaps even for good. Of the major strategic blocs, only Europe seemed unwilling until recently to accept the paradigm shift, believing that it could still act according to the rules of globalisation..

How does the big picture look now? At the centre is the strategic competition between the United States and China. The (primarily military) rivalry between the US and Russia had dropped out of view somewhat, but is now very much back in the spotlight. New connections are being created: a Russia that is economically cut loose from the West will – by necessity – have to move closer to China. The ties between Europe and the US (transatlantic alliance) are becoming stronger again. For other countries, it is ultimately about spheres of influence – who will be dependent on whom, who will forge ties with whom, and who will try to steer a relatively neutral course?

[2] See our study papers 'Systemschock für den Welthandel' ('A systemic shock for global trade') published in August 2020 and 'Vom Tradewar zum Techwar' ('From trade war to tech war') published in November 2020.

Figure 1: It's all about spheres of influence



* Aggression against Ukraine. Sources: Peterson Institute, UN, Union Investment.

The new Cold War is in some respects more complex than its historical predecessor. In addition to the classic military dimension, it has additional '21st century' aspects: digital supremacy, cybersecurity, supply chains, social media spheres and so on. And the global finance system is also a key component, as the freezing of Russia's currency reserves and its partial exclusion from the SWIFT system have shown. The economy and capital markets are affected more directly and in more diverse ways than was the case before 1990.

The situations of China and Russia are not the same and they do not share the same interests. Ultimately, Russia is a waning great power that has long been unclear about the agenda it is pursuing beyond pure power politics – other than somehow disturbing the world order, as demonstrated by its hacking attacks on western states and companies. Viewed in this light, Russia is first and foremost a security risk.

China's agenda, on the other hand, is very clear: it is a great power on the rise that wants to be number one. It wants to reshape the world order in its own favour. The strategic competition with the West is mainly being played out in the economic and technological spheres – for the time being, at least. However, the possibility of this competition being shifted to a military level in future cannot be ruled out (see also Proposition 5).

The world has become more unstable

Whatever level the competition between great powers is being played out at, the world is less stable than it was when globalisation was at its peak. Globalisation stood for interconnectedness and ultimately for common interests, namely reaping the benefits of the international division of labour. Mutual dependencies kept (economic) relations in balance. Great-power competition, on the other hand, is all about fragmentation and competing interests – the Cold War model. Russia's attack on Ukraine has made the world a lot more unstable.

New ground rules are needed

This is wholly typical for the initial phase of a change to the geostrategic configuration as new rules have yet to be established. In the early phase of the

Cold War, this instability was expressed in the Berlin blockade and the Korean war, and then in the Cuban missile crisis. Viewed through this lens, it is perhaps no coincidence that the rhetoric on the possible use of nuclear weapons – in this case by Russian President Putin – is now harsher than it has been since the Cuban missile crisis in 1962.

Implications for the capital markets

- More instability generally means more macrovolatility in the capital markets. The impact of the war in Ukraine on the capital markets may have receded a little for now, but its indirect effects are still causing volatility. One example is the greater pressure on the central banks due to the effects of inflation.
- Less globalisation means a reduction in the economic benefits of the international division of labour, which broadly means lower growth and higher prices. But the effects on individual countries, regions and companies will be very different. As always, there will be winners and losers (see propositions below). Export-led Germany is undoubtedly one of the countries facing the greatest challenges.
- In and of itself, Europe's greater proximity to Russia imposes a geopolitical risk premium on European assets (see Proposition 4).

Proposition 2: Reduction of strategic dependencies will bring higher inflation – and more growth

After the escalation of the US-China conflict in 2017 and the coronavirus pandemic in 2020, the war in Ukraine is now the third event to bring the issue of international strategic dependencies to the fore.

Tensions between the US and China have so far focused on the high-tech sector. China has long been dependent on the West, and especially on the US, in this area, particularly for high-end chips. At company level, the coronavirus pandemic exposed the dependencies of international supply chains. There were (and still are) huge problems both in the manufacture and the transport of end products and intermediate products. Unsurprisingly, the medicines and pharmaceuticals sectors were areas where specific strategic dependencies became especially apparent, for example in protective clothing for medical staff and the materials needed to produce vaccines.

War brutally exposes dependencies

The war in Ukraine has elevated the problem to a new level in two respects. Firstly, additional areas of strategic dependency have come to light. These include armaments, of course, and the energy sector where many European countries are heavily dependent on Russia (see Proposition 3). But the agricultural sector (wheat, cooking oil and fertiliser) is also affected, along with a number of metals such as palladium and nickel, some of which are needed for the transition to a green economy[3]. Secondly, however, the context in which these dependencies are located is different to the context in which the

[3] See our study paper 'Rohstoffmärkte werden grün' ('Commodities go green') published in November 2021.

coronavirus crisis was dealt with. The key takeaway from that crisis was the need to prepare for the risk of similar pandemics in future, whereas the dependencies affected by the war in Ukraine have to be viewed in the light of the new great-power competition. In other words, this is not an ‘event risk’ but a structural geopolitical trend.

Production brought closer and with ‘friends’

We have heard a lot about ‘reshoring’ and ‘nearshoring’ in recent years, and another neologism has now been added to the lexicon: ‘friend-sourcing’. Reshoring and nearshoring refer to the process of bringing at least part of the production of intermediate or end products ‘home’ or relocating it to a country closer to home. In the case of Donald Trump’s ‘Make America Great Again’ policy, this had geopolitical connotations, but in the context of the coronavirus pandemic the rationale was that longer transport routes make supply chains more vulnerable per se.

As the name suggests, ‘friend-sourcing’ is about establishing or expanding trade relations with like-minded, politically stable partners. Ideally, these are countries such as the resource-rich democracies of Australia and Canada, and, with some reservations, Mexico. But better relations could also be sought with other Latin American countries such as Brazil, which has been sidelined by the controversial policies of President Bolsonaro. The ‘friend-sourcing’ strategy also aims to prise countries that are geographically on the doorstep away from the influence of Russia or China, and to forge closer ties with them. For Europe, this includes North Africa for example, and, for the US, Venezuela. In both cases, the target countries currently have closer ties with both China and Russia.

Enforced upheaval can unleash innovative forces

The instability that the Ukraine war has created for the world, the emerging new world order, has greatly increased the pressure to reduce strategic dependencies. In other words: this process has to move faster, as the example of Europe’s energy security shows (see Proposition 3). But faster generally also means more expensive to begin with. Economically, in the medium term this may lead to high growth rates *and* higher inflation at the same time. Why? Phases of upheaval that are driven in part by (the expectation of) high costs offer strong incentives for investment and innovation. The first phase of the Cold War was also shaped by technological competition which ultimately laid the foundation for the emergence of Silicon Valley. Ideally, such upheaval will lead to a mission like the moon landing, will unleash positive forces and will result, via technological advances, in higher growth and greater productivity. The production, use and storage of energy are contemporary examples – innovation that seemed unattractive under the ‘old’ conditions or was envisaged as a medium-term objective (such as the transition to a green economy), suddenly looks extremely interesting. States can encourage this through both regulatory intervention and targeted investment incentives.

Structurally higher inflation rates

However, there are areas in which innovation potential is limited and where prices will simply rise. Supply bottlenecks for certain commodities can only be resolved in the long term, if at all, because it generally takes many years to expand capacity. These are the areas that will cause medium-term inflation rates to be higher than had been expected before the invasion of Ukraine.

Implications for the capital markets

- Provided that the innovation and investment surge outlined above is sufficiently dynamic, which we assume it will be, the current stagflationary tendencies should remain a short-term and temporary phenomenon. Higher growth and productivity increases in the medium term will increase company profits, first and foremost in those sectors that are affected by the reduction in strategic dependencies. Businesses that are involved in the construction of new production facilities stand to benefit the most. Equities will be the most favoured asset class. Logistics companies with global operations could be among the losers in the medium term.
- Higher commodity prices will be the main driver of a supply-induced elevated level of inflation. Monetary policy cannot directly influence this aspect of inflation, which puts the central banks in a tricky position. Balancing central bank policy between supply and demand effects will be like walking a tightrope and the risk of making a mistake and choking off growth is high. The key question for the companies concerned is whether they can pass price rises on to consumers or whether they will be forced to reduce their margins.
- Nominal interest rates will rise because (aside from higher base rates) the investment necessary to reduce strategic dependencies will increase demand for credit. Under the (realistic) assumption that the demand effect of capital spending and second-round effects will remain sufficiently high in the medium term, real interest rates will also rise (overcompensation or reduction of supply-induced inflation).

Proposition 3: The pathway to becoming climate-neutral will be different

Energy security is probably the greatest strategic dependency of the West – and of Europe in particular. More than 40 per cent of the EU's gas supply and around 25 per cent of its oil imports currently come from Russia, while the figure for coal is almost 50 per cent. Having embraced globalisation and allowed itself to become dependent on an unpredictable, authoritarian regime, Europe (and especially Germany) is now reaping what it sowed. Looking ahead, there is a particularly bitter edge to the energy supply situation created by the war: in the *short to medium term*, energy importers may struggle to secure supplies of precisely those fossil energy sources whose consumption they had intended to greatly reduce in the *long term* as part of the fight against climate change. It is not as if the pathway to becoming climate neutral over the next two to three decades had been precisely mapped out before the Russian invasion, but one thing is certain: the war will alter its course, at least for Europe.

Energy supply chains must be radically redesigned

Any analysis must carefully distinguish between crude oil, refined oil, such as diesel, and natural gas. It is also important to differentiate between the global, aggregate supply/demand situation for energy commodities, and the supply dependency of certain regions such as the EU (or the West as a geopolitical bloc). For example, crude oil is easier to transport than natural gas so the market for it is global. In the medium term, it is therefore unlikely that the quantity of crude oil traded globally will decrease significantly. Russia will be able to sell a large proportion of its oil – which accounted for around 11 per cent of global production before the start of the war – to other countries such as India and China. Third countries will step up their extraction (e.g. the US with shale oil) or generally play a more important role in the market again (Iran, Venezuela).

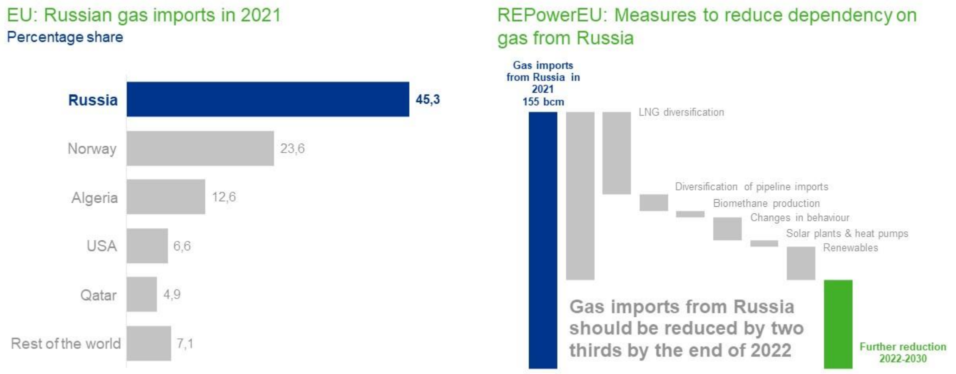
The rise in the oil price we have been witnessing since around November 2020 – *before* the outbreak of war – was predominantly demand-driven rather than supply-driven. History tells us that, sooner or later, this pattern will reassert itself: supply shocks in the price of oil have always tended to be short-lived.[4] In other words, it is realistic to expect that the price will normalise. And yet, from the EU's perspective, the question is where exactly the oil will come from in future to replace the volume previously purchased from Russia. In accordance with the 'friend-sourcing' principle described above, the United States is likely to play a more important role here than before. Unlike Europe, the US is not reliant on energy imports. If the prices support profitable extraction of significantly larger quantities of shale oil, which is the case again now, there will even be substantial reserves available for export.

Natural gas is Europe's Achilles heel

Of all Europe's strategic dependencies, natural gas presents by far the greatest challenge. There are two main reasons for this: firstly, it sources a far higher share of its supply from Russia (over 40 per cent, as mentioned above) and secondly, gas is harder to transport and therefore more infrastructure-dependent. A detailed discussion of possible solutions is beyond the scope of this paper, and it is probably too soon anyway. The fundamental questions are however obvious: (1) Who could and should be the gas suppliers of the future? (2) What investment is necessary – both in the supplier countries and within the EU – and what needs to happen for this investment to be made?

[4] See our analysis 'Bremst der Ölpreisschock den Aktienmarkt aus?' ('Will the oil price shock act as a brake on the equity markets?') published in March 2022.

Figure 2: The West is aiming for energy independence



Sources: European Commission, Union Investment.

Point (1) favours politically stable and friendly fossil-fuel producing countries (see above).[5] For gas, too, the US is therefore likely to play a more important role for Europe in future. Point (2), however, raises a new aspect that will have an impact on the timeline for the transition to a green economy. Investment is needed to expand capacity (wherever that may be) and to transport the greater quantities involved. Energy infrastructure projects have long amortisation periods and, mindful of the climate-neutrality targets, private investors will demand reassurances that the plants will continue to operate for a sufficiently long period. Put another way: it would be naive to think that companies will invest in technologies with a clear expiry date and risk simply being a stepping stone for the rapid and seamless transition to a zero-carbon economy. Our hypothesis is therefore that there will (have to) be a noticeable shift in climate policy and a recalibration of the relevant regulatory framework. In particular, coal will have to be used more intensively, and consequently for longer, than planned. If the incentives are sufficiently well-designed, new investment in the area of fossil energies will at least use cutting-edge technology. The watchword here is 'as clean as possible'. The situation will also give fresh impetus to plans for new nuclear power stations in France, for example, and extend the life of old plants.

Significant shift in climate policy required

Might the transition to renewable energies even end up being accelerated? This question is also beyond the scope of this paper, but it is plausible to assume that a three-pronged approach will be adopted, given the pressing nature of the situation. (1) Create short to medium-term energy security via new fossil-fuel suppliers and relevant investment, and by using existing capacity more intensively and for longer. (2) Accelerate the expansion of renewable

[5] It remains to be seen whether this description also fits states such as the Emirate of Qatar, which is one of the world's biggest producers of LNG and was recently visited by German economics minister Robert Habeck. Qatar can currently be described as politically stable, but opinion is divided on the question of whether it is a friend. Although the description certainly fits Qatar better than the United Arab Emirates.

energies and provide greater support for technological innovation (e.g. green hydrogen). (3) Promote energy-saving measures e.g. in buildings.

Energy transition may be accelerated in the longer term

Given the time horizon for becoming carbon neutral (2050, or 2045 for Germany), for Europe this could mean that the reduction of emissions will initially slow somewhat, or that emissions could even rise in absolute terms over the next few years. Put another way: the ramping up of energy-saving measures brought about by the pressure of the current situation will not on their own be enough to offset the increased use of coal. In the middle phase (roughly speaking, the 2030s) the net effect is less clear-cut. The use of new fossil fuel infrastructure for longer, as described above, will detract from the positive effect of energy-saving measures and a move towards greater use of renewable energies. But it is possible that emissions will be reduced at a faster rate than originally anticipated, if not in this phase then by the 2040s at the latest. Ultimately, this could even result in the energy transition being completed a few years earlier than planned.

In the US, the implications for the emissions reduction path are less clear. The United States is self-sufficient in terms of energy, although even here prices are likely to rise and thereby create incentives for greater energy saving and the expansion of renewables. On the other hand, the more prominent role of the US in Europe's energy supply will also require the extraction of fossil fuels to be stepped up, with the implications outlined above. No changes are currently expected for India and China, whose climate policies are in any event less ambitious.

Implications for the capital markets

- Higher energy costs (at least for natural gas) coupled with changes to the regulatory framework and subsidies will alter the operating environment, particularly for energy-intensive businesses. However, the responses to this are likely to vary widely.
- Manufacturers of infrastructure for the gas and oil industry, but also for renewables, the circular economy and heating technology powered by renewable sources will benefit (including from simplified and speeded-up approval procedures).
- The US energy industry will be one of the main beneficiaries in the short to medium term.
- Latin America could also experience a renaissance after the 'Bolsonaro and Maduro depression' and become more interesting to investors again.

Proposition 4: Europe and the West will move closer together

Given the horrific events in Ukraine, it would be inappropriate to talk about any good coming out of the situation. But we can at least recognise as progress and potential opportunity the fact that the western world is taking a wise old saying to heart: “When faced with adversity, put aside your differences and pull together.” The West’s response to the Russian invasion has so far been very united – both in terms of the transatlantic alliance between the United States and Europe, and within the EU.

In terms of the role played by the US in the war-related strengthening of the transatlantic alliance, one might think that things could have looked very different if Donald Trump were still president. This raises the question of what will happen if someone other than Joe Biden is voted into the White House in two and a half years’ time. It is pointless to speculate here and now, but we can say this: at least within the upper echelons of the Republican Party, events have sharpened awareness that in some situations it is more important than ever to have a politically experienced and level-headed president.

The lessons for the EU are somewhat different. While Europe may have shadow-boxed around China and Russia for the sake of its economic interests during the age of globalisation, the war in Ukraine has made it very clear which bloc the EU belongs to. For Germany and its globally operating companies in particular, it will now be even trickier to find the right position on China, as Russia has provided an object lesson in how quickly direct investment in and trade with an authoritarian and aggressive regime can go wrong. Conversely, the intensity of relations between the EU and the US, including their economic ties, will be strengthened, especially in the energy sector (see Proposition 3).

Chance to further strengthen the EU

The current situation undoubtedly also creates an opportunity – in some areas even a need – for closer integration within the EU. For a time at least, external threats will create momentum to close ranks. There has been speculation that one of the reasons why Russia’s President Putin was not deterred from invading Ukraine was that he thought the EU was weak. Viewed through this lens, it is in the EU’s security interest to demonstrate unity and strength. One thing is clear, however: this momentum will start to be lost at some point. So the quicker things happen now, the greater the progress towards integration could be.

In individual areas such as defence policy, the refugee and migration problem, energy security and agriculture, EU member states would be well advised to act in concert. Take energy security, for example. Certain infrastructure issues such as intra-European pipelines for LNG gas can only be solved at supranational level. And if every country acts individually to secure new energy suppliers, prices will be driven even higher. In other words, in a situation of critical shortages, the EU must at least pool its purchasing power and act strategically to avoid inefficiencies – and not compete with one another.

Further integration of fiscal policy and financing is needed

Strengthening the defence capability and reducing strategic dependencies will require high levels of public and private investment – not to mention the spending required for the transition to a green economy. Greater fiscal integration within the EU also has to extend to funding, because somehow all this has to be paid for. This will fuel calls for a stronger common tax policy and of course for a capital markets union. In any event, a very well-functioning European capital market is needed. Whether all this will ultimately result in the much discussed 'eurobond' remains to be seen. But structures such as the recovery fund created in response to the coronavirus pandemic (which differs from regularly issued eurobonds only in terms of its one-off character and the details of the liability) will presumably also be the subject of wider discussion in the coming years. In other words, one way or another, there will be more bonds issued by the EU. And direct subsidies for capital expenditure projects (instead of pure credit) will play an increasingly important role, as they did with the recovery fund.

Maastricht rules in the spotlight

During the coronavirus pandemic, the borrowing rules agreed in the Maastricht Treaty were suspended until the end of 2022. That deadline is now set to be extended again, and there is doubt as to whether the rules will ever actually come back into force in the same form. Given the necessary investment in resilience, climate policy and digitalisation, a great deal of funding flexibility will be required for a number of years, and rigid rules would prevent this.

In the years that followed the financial and sovereign debt crisis, there was a great deal of speculation about a possible disintegration of the EU. This was expressed in the capital markets in a kind of political risk premium for European assets. During the coronavirus crisis, the EU succeeded in bringing the benefits of acting in concert to bear (albeit after some initial difficulties such as border closures and countries going it alone in the procurement of medical equipment). The agreement on a recovery fund was a fundamental turning point – in a positive sense. And even for the procurement of vaccines, the will to act together won out in the end. The Ukraine war has the potential to further boost this trend, which would be rewarded by the capital markets.

Implications for the capital markets

- Closer EU integration has the potential to further reduce the 'internal political' risk premium for European assets imposed at the time of the sovereign debt crisis. This would go some way towards compensating for the geopolitical risk premium resulting from the proximity to Russia.
- The pressure to increase investment has grown (further) in various areas, including defence, energy, digitalisation and cybersecurity. Companies in these sectors will benefit.
- The importance of bonds issued at EU level will continue to grow and the trend towards genuine eurobonds will become stronger.
- The role of fiscal policy will become stronger, which may reduce the focus of the capital markets on western central banks.

Proposition 5: The war is fundamentally changing China's position

The Russian invasion of Ukraine presents China with a number of problems. Firstly, its support for Russia puts Beijing on the defensive. Secondly, the concerted response of the West to the war of aggression provides a blueprint for what China could expect if it attempts to annex Taiwan. Beijing's political decision-making scope has shrunk and its further journey as an emerging global power has become more risky.

Accelerated decoupling of China

The current great-power competition between the US and China (and now also between the West and Russia) will lead to the emergence of new blocs in the medium term, as we have already explained elsewhere (see Proposition 1).[6] The war in Ukraine is likely to speed up this decoupling of China because the pace, resoluteness and unity with which the West responded to the Russian invasion will compel China to clearly stake out its position earlier than its leaders had planned. And since it is unlikely to move closer to the NATO positions, Beijing will have no option but to step up its efforts to detach itself from the West.

The great-power competition between China and the US is not the same as the current conflict between Russia and the West (see Proposition 1). In terms of economic and innovative strength, for instance, Russia is miles behind China. But there are nevertheless parallels between the conflicts, one of which relates to China's approach to the Taiwan question. For China, it is a matter of 'reunification' with (from its perspective) a territory that has always been part of the People's Republic. The Communist Party leadership does not accept arguments for the autonomy and independence of the highly developed industrial economy. Although there has been a rapprochement between China and Taiwan in recent decades – particularly as a result of close economic integration – China's ambition to absorb its much smaller neighbour remains a key policy objective. And there is little doubt that the will is there to implement this policy in the long term.

[6] See our study paper 'Vom Tradewar zum Techwar' ('From trade war to tech war') published in November 2020.

Security guarantees for Taiwan, but not for Ukraine

In contrast to Ukraine, which, like Taiwan, is not part of the EU or NATO, the US has given Taiwan clearly formulated security guarantees. Asked in October last year whether the US military would come to Taiwan's defence in the event of an attack by China, President Joe Biden answered, "Yes, we have a commitment to do that."[7] However, in the worst-case scenario, the United States would face a dilemma. Despite being of immense strategic importance, Taiwan – like West Berlin during the 'first' Cold War – would be significantly harder to defend in the event of an actual attack than a state encompassing a large land area such as Ukraine.

Despite everything, the swift and robust response of the West to the Russian invasion of Ukraine means China will shelve its plans for Taiwan. It will only risk an attack on Taiwan if the risk of failure is as good as impossible. And that will only be the case when the country has further expanded its power and its military capabilities through greater technological and economic progress.

We do not expect China to achieve this status before the end of the decade. But this also means that China's ties with the West will have to be drastically reduced by then. In addition to technological dependencies, such as in the semiconductor industry, this applies in particular to the global financial system. Decoupling is likely to involve switching from US dollars to China's own renminbi for commodities trading, reducing its currency reserves and developing its own payment system (see Proposition 6).

China and Russia move closer together

The cooperation between China and Russia will intensify, with China dictating the terms. In a nutshell, Russia will become China's fuel station while in return, Russia hopes to get technology from China that it can no longer obtain from the West because of the sanctions.

However, China will always take a controlled approach. Beijing will not get involved in Russia's geopolitical manoeuvring, just as it will not currently move to undermine the West's actions too obviously. China cannot risk having harsh sanctions imposed on it at present. It is still too reliant on foreign imports, especially for high tech. A ban on the import of key goods would hit China hard and jeopardise its ambitious plans for the future. A rapid further deterioration of the already cool relations with the West is therefore not in China's interest.

It will probably also be much harder for the West to decouple quickly and incisively from China than was and is the case with Russia. China's economic importance is far, far greater – for states and businesses – and the integration is many levels deeper. However, it is uncertain how states and companies would deal with a sharp increase in public pressure. The reputational risk is immense.

Implications for the capital markets

[7] Joe Biden: USA würden Taiwan gegen Angriff Chinas verteidigen (Joe Biden: United States would defend Taiwan in the event of an attack by China) | ZEIT ONLINE (22 October 2021)

- Western companies will be cautious about doing business in China in the medium term. The punishing sanctions against Russia have shown how rapidly direct investment can become worthless. More and more western companies are pulling out of Russia completely, in part due to strong public pressure, and a similar scenario is conceivable for China. For investors, this means that organisations with large direct exposure to China will initially be subject to a risk premium.
- The pressure on Chinese assets will continue to grow. Firstly from Chinese regulators and secondly in view of sanctions that could potentially be imposed by the West – if there were an escalation of the Taiwan situation, for example. Russian shares were non-tradable for just under four weeks, making them practically worthless to foreign investors and for some entities, such as banks, the current Russian sanctions mean there is no longer any basis for doing business there.
- Any (sanction-related) payment default by individual companies or even by the state as a whole would also affect bond investors.

Proposition 6: In the long term, the US dollar will lose (some of its) importance as a global reserve currency

With the freezing of parts of Russia's currency reserves and the exclusion of several Russian banks from the SWIFT international payments system, a taboo has been broken. Although the US has repeatedly used the dominant role of the dollar in the global finance system to enforce economic sanctions in recent decades, the extent – and above all the concerted nature – of the West's action against Russia is unprecedented.

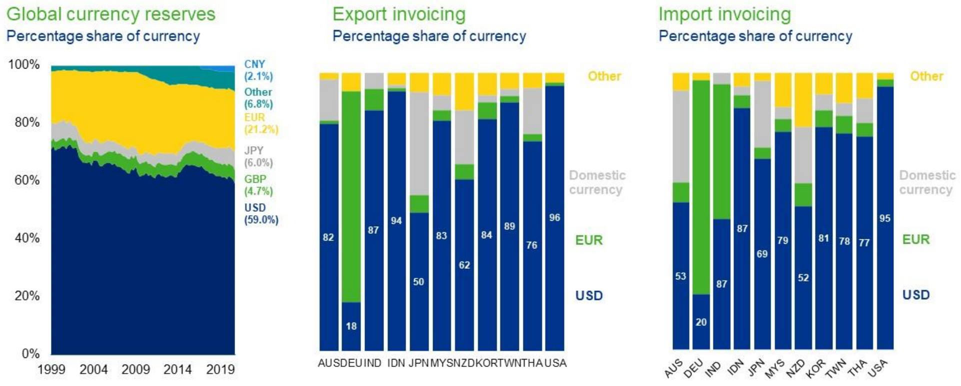
Russia itself says that it has lost access to around US$ 300 billion of its reserves, thought to be worth a total of US$ 640 billion. According to the Russian central bank, in June 2021 around 16 per cent of its reserves were held in US dollars, 32 per cent in euros and 13 per cent in the Chinese renminbi. It is likely that its Chinese reserves will remain available as China wants to maintain economic relations with Russia (see Proposition 5).

Turning point for the US dollar as a reserve currency

However, the current situation signals a turning point for the US dollar, which still makes up almost 60 per cent of global currency reserves (see figure 3), because the tough and rapidly imposed sanctions also send a clear message to other countries: in a conflict with the West, currency reserves in western currencies may be worthless. As well as the US dollar, the euro, the Japanese yen and pound sterling may thus lose their importance as global currency reserves in the medium to long term, at least for some countries.

States that could potentially come into conflict with the West – including

Figure 3: The West has broken a taboo by freezing Russian central bank reserves



Sources: International Monetary Fund, Union Investment.

China (see Proposition 5), with currency reserves currently totalling around US$ 3.2 trillion – will start to look around for alternatives. There are not many options at present. Take gold, for example. The precious metal meets the requirement as a store of value and the US, UK, Japan and the four major euro economies hold around 40 per cent of their currency reserves in gold. However, gold cannot compete with the US dollar in terms of liquidity and market size. Furthermore, the G7 heads of state and government want to prohibit the Russian central bank from trading in gold as part of the further tightening of sanctions, so this is not a viable option for a rapid move away from the US currency either.

Gold and cryptocurrencies will benefit

But gold is likely to benefit significantly in the medium term. China currently holds only relatively small gold reserves. If it were to increase its reserves to a level similar to that held by Russia (approximately 20 per cent), this would represent a six-fold increase. To reach US levels, it would have to increase its reserves by a factor of 20. This would require tens of thousands of tonnes of gold – an inconceivable amount on the gold market. Only around 3,500 tonnes are mined a year.

At the same time, China will seek to speed up the process of reducing its dependency on the US financial system. This includes setting up its own payments system and linking up with partners outside the western world. It is also likely to accelerate the introduction of digital central-bank currencies[8]. Finally, China will also push for greater use of its own currency for commodity trading. According to recent media reports, Saudi Arabia is among the countries considering accepting renminbi for exports to the Far East.

Overall, the importance of the US dollar is likely to decrease to some degree in the long term, which will also reduce the effectiveness of financial sanctions. There are signs that this is already happening, with Russia trying to get

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[8] See our study paper 'Lieber spät als nie' ('Better late than never') published in November 2021.

other countries to pay for their energy in roubles instead of euros and dollars as a means of shoring up the domestic currency against western currencies.

Cryptocurrencies are also likely to benefit from this development. Their volatility means they are not suitable as stores of value and thus for use as a reserve currency, but they are useful as a sanctions-busting payment tool and we can therefore expect to see them used more frequently in similar situations.

Implications for the capital markets

- In the long term, alternatives to the US dollar and other western currencies are likely to benefit. In addition to gold and cryptocurrencies, these include the Chinese renminbi, whose role would be boosted in areas such as commodity trading.
- US bonds will probably fluctuate more sharply and their yields will rise. There are many reasons for this. Firstly, there will be a greater risk of major market players such as China divesting parts of their substantial holdings. Secondly, there would be no demand for the new issues from parties in conflict which means – thirdly – less liquidity and thus higher volatility.
- In such a scenario, the US dollar would come under downward pressure for similar reasons.

What happens next depends on use of the dollar in global trade

However, it is also clear that this scenario very much depends on whether and to what extent the US dollar is dislodged from its position as a reserve currency in international trade. It is still doubtful whether China has the necessary bargaining power to bring about structural change in this respect. As long as the dollar continues to dominate this arena, most of the consequences for reserve currencies described above will not materialise. For many countries, the western currencies are still the most reliable reserve currencies as they are supported by innovative and dependable states that are based on the rule of law.

For commodity exporters, too, a move away from the US dollar in favour of the Chinese renminbi would not be entirely beneficial, as it would create new dependencies. And the West remains the most important customer for Chinese exports, which means that China still has a long way to go in terms of achieving independence (see Proposition 5).

Most importantly, however, the likelihood of an end to ‘dollar hegemony’ has increased. And speculation about this could in itself be enough to affect the capital markets.

Conclusion

The propositions outlined above focus on the most important geopolitical and economic aspects of the Ukraine war, in so far as they have a medium to long-term structural effect. We have left out or merely touched upon a number of equally relevant topics, such as the impact on the agricultural and food sectors, the now even more complicated refugee situation, and the impact on digitalisation (including cryptocurrencies and cyberattacks).

High volatility in the transition phase

However, the topics that are discussed in this paper provide a broad outline of a fundamentally changed global economy – and the effects of these changes on the capital markets. The transition to this new order will be a period of significantly increased volatility on the stock markets. On the positive side, we see confirmation of the proposition we put forward in the context of the coronavirus pandemic: that there is the potential in the medium term for a sustained, steeper growth trajectory. The pressure to reduce strategic dependencies, restore energy security and push ahead with the transition to clean energy has become even greater and means we can expect significant capital expenditure, coupled with the opportunity for a leap forward in innovation in many areas. Looking ahead, higher real interest rates could follow on from the initial nominal increases – another ultimately healthy development.

Inflation remains high: a challenge for central banks

The expected rise in fossil fuel prices is a double-edged sword. On the one hand, in the context of the climate crisis, price rises are a useful incentive to encourage us to use less energy. But at the same time, when coupled with the rising prices of other commodities, they are likely to drive inflation back up to a high level in the medium term. Monetary and fiscal policy will have to tread a fine line, ensuring that any measures introduced do not push up prices too steeply. Above a certain level, as we pointed out in our white paper for the 2021 risk management conference[9], this would be harmful, especially for risk assets.

Winners and losers: the deck is reshuffled

The move towards a new political and economic world order will create winners and losers in both the real economy and the financial markets. This applies both to states and to private companies. It is clear that a geopolitical development such as the formation of new blocs will mean many changes at the level of individual countries. As the quotation at the start of this report suggests, few countries will be more affected by this than Germany. Nonetheless, there are grounds for cautious optimism: Germany is a rich country and is entering this process from a position of strength. And the high proportion of economically strong and flexible small and medium-sized enterprises should work strongly in Germany’s favour.

[9] Michael Herzum, Sandra Ebner, Sven Schömer – Investmentwelt post Corona: Ein neues Drehbuch für Portfolios? (Post-coronavirus investment world: a new script for portfolios?) Available via this link.

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Disclaimer

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